Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
AT&T Corp.	)	
	)	RM No. 10593
Petition for Rulemaking to Reform	)	
Regulation of Incumbent Local Exchange	)	
Carrier Rates for Interstate Special	)	
Access Services	)	

COMMENTS OF WORLDCOM, INC.

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I. Introduction and Summary

Three years ago, the Commission made a prediction: if certain "competitive triggers" were met in any Metropolitan Statistical Areas (MSA), increased special access pricing flexibility would allow incumbent local exchange carriers (ILECs) to respond to competition by selectively lowering prices without being able either to exclude new entrants or to raise rates to unreasonable levels.[1] That prediction has proven inaccurate. ILECs have used pricing flexibility to *increase* special access rates without any apparent concern about losing business to competitors.[2] ILECs have not found it necessary to selectively reduce prices on special access routes due to the presence of facilities-based competitors. Special access rates are now higher for virtually every rate element in pricing flexibility areas than in non-pricing flexibility areas.[3] Finally, it appears that ILECs with pricing flexibility are

[1] In the Matter of Access Charge Reform, CC Docket No. 96-262, Fifth Report and Order (rel. August 27, 1999) (*Pricing Flexibility Order*), ¶ 68.
[2] *See, e.g.,* Qwest Corporation, Transmittal No. 145 (filed October 31, 2002), increasing DS1 rates virtually across the board in pricing flexibility MSAs, density zone 1.
[3] AT&T Petition at 13.

well situated to engage in exclusionary pricing behavior.

Pursuant to Public Notice DA 02-2913 (rel. Oct. 29, 2002), WorldCom, Inc. (WorldCom) respectfully submits these comments in support of AT&T's petition for rulemaking to reform regulation of price cap ILEC rates for interstate special access services (filed Oct. 15, 2002). As AT&T has shown, special access prices charged by the largest ILECs, the Bell Operating Companies (BOCs), grossly exceed any reasonable measure of cost. As a consequence, the BOCs have garnered exorbitant returns on special access services at the expense of their captive special access customers. These returns equate to a massive transfer of money and investment to the BOCs from their retail customers, the rest of the telecommunications sector, and the national economy.

To make matters worse, by allowing the ILECs to remove the vast majority of special access services from price regulation, the Commission has made it possible for the ILECs to pursue exclusionary pricing strategies. Under pricing flexibility, ILECs can price their services in a manner that effectively prevents special access customers from building their own facilities and using alternative vendors. The mere threat of such behavior is a substantial barrier to entry that must be removed.

WorldCom agrees with AT&T that the Commission should promptly revoke pricing flexibility and reinitialize price caps to levels that will produce normal returns for the BOCs. The Commission should also, as an interim measure, (1) reduce all special access rates subject to Phase II pricing flexibility to levels that would produce an 11.25% rate of return, and (2) impose a moratorium on consideration of further pricing flexibility applications pending completion of the rulemaking.

II. ILEC Special Access Services are Grossly Overpriced

AT&T has shown that ILEC special access prices greatly exceed any measure of their actual cost. Special access prices are routinely more than 100% higher than corresponding unbundled network element (UNE) prices.[4] And they are sometimes 200% or even 400% higher.[5] The BOCs' repeated demands for restrictions on the uses to which UNEs may be put, demonstrates that UNEs can be used to replicate special access functionality. UNE prices have been established by state commissions in cost proceedings according to a methodology (TELRIC) that has been approved by both this Commission and the United States Supreme Court. Special access prices that are double, triple, and even quintuple state-adjudicated rates for the identical functionality far exceed the ILECs' actual costs.

AT&T has also shown that the ILECs have been earning exorbitant returns from special access, even based on embedded cost information. Indeed, their own ARMIS data show that in 2001 the BOCs made special access rates of return that ranged from 21.72% to 49.26%.[6] Moreover, their rates of return on special access services have increased every year since 1996.[7] Thus, even in relation to their embedded costs the BOCs have earned extraordinary rates of return at the expense of their special access customers and the national economy.

AT&T estimates that BOC 2001 special access revenues exceeded the level that would produce an 11.25% rate of return by *more than $5 billion*.[8] The loss to the economy

[4] AT&T Petition at 10.
[5] *Id.*
[6] *Id.* at 8.
[7] *Id.* at 9.
[8] *Id.* at 8.

is undoubtedly much greater. The BOCs' special access customers include competitive local exchange carriers (CLECs), interexchange carriers (IXCs), and end users including Internet service providers, businesses, governmental entities, and educational institutions. By maintaining prices so far above cost, the BOCs are significantly restricting output of special access services. Lower prices would be met with greater demand for special access, which would result in greater demand for network and customer equipment, as well as greater demand for the interexchange services that depend on special access. There can be no justification for allowing the BOCs to inflict this massive injury on the telecommunications industry, its customers, and the economy.

III. Commission Policies Have Left Special Access Rates Far Above Cost

Over the past decade, dramatic technological advances have substantially reduced the ILECs' cost of providing special access services. Transport costs have declined substantially due to the near-complete replacement of copper facilities with optical fiber. And loop costs have also declined, due in large part to the replacement of costly T1 technology with HDSL.

In principle, those reductions in the ILECs' cost of providing special access services should have been reflected in lower special access prices. Under price cap regulation, the X-factor is designed to capture advances in ILEC productivity, including reductions in the cost of providing special access services, and translate those cost reductions into annual price reductions. And the "triggers" adopted in the *Pricing Flexibility Order* were intended to ensure that special access prices reached competitive levels in those MSAs where the ILECs were freed from price cap regulation.

The evidence shows, however, that the Commission's decisions in the price cap and pricing flexibility proceedings have failed to ensure that declining cost of providing special access services is passed through to customers. As is illustrated by the skyrocketing ILEC rates of return, the Commission's policies have permitted the ILECs' special access prices – already well above cost in 1997 – to diverge even further from cost over the last five years.

A. The Failure of the Commission's Regulatory Regime Has Allowed the Gap Between Special Access Prices and Costs to Increase

The 1997 *Access Reform Order* began the process that led to today's dramatically inflated ILEC special access prices. In that order, the Commission decided to "borrow" price cap reductions from special access services and instead target those price cap reductions to the non-cost-based Transport Interconnection Charge (TIC).[9] Because the special access price cap reductions were retargeted to the TIC, most LECs did not reduce special access rates in either the 1997 or 1998 annual access filings. Some LECs, such as the former Bell Atlantic, continued to borrow X-factor reductions from special access services even in the 1999 annual filing.[10]

After a single year – 1999 – in which most (but not all) ILECs applied a full X-factor reduction to their special access services, special access price cap reductions were largely suspended again in 2000. Pursuant to the *CALLS Order*,[11] the ILECs applied a special X-factor of only 3 percent to the special access basket in 2000, rather than the full 6.5 percent

[9] In the Matter of Access Charge Reform, *First Report and Order*, CC Docket No. 96-262, released May 16, 1997, ¶¶ 235-238 (*Access Reform Order*).
[10] *See*, *e.g.,* Bell Atlantic Transmittal No. 1148, June 16, 1999, TRP Chart PCI-1.
[11] In the Matter of Access Charge Reform, *Sixth Report and Order*, CC Docket No. 96-262, released May 31, 1997 (*CALLS Order*).

X-factor applied in the later years of the CALLS plan.[12] With GDP-PI about 1.6 percent in 2000, the special 3 percent X-factor resulted in only minimal special access nominal rate reductions in the 2000 annual filing.

Market discipline did not take the place of the foregone price cap reductions. Even though the special access price cap was artificially elevated by the Commission's decision to retarget or suspend price cap reductions, the ILECs were able to continue pricing at that elevated cap throughout the 1997-2000 period. Competitive forces were not sufficient to keep prices declining in line with the ILECs' cost reductions.

The cumulative impact of the foregone price cap reductions that resulted from the *Access Reform Order* and the *CALLS Order* has been significant. Rather than declining approximately 20 percent between 1997 and 2000, as would have been the case had the 6.5 percent X-factor been applied to special access services in the 1997, 1998, 1999, and 2000 annual access filings, the ILECs' special access prices declined only about 5 percent during that period.[13] For those ILECs, such as the former Bell Atlantic, that were required to target X-factor reductions to the TIC in 1999, the reduction in special access prices was even smaller.

Although full X-factor reductions finally resumed in 2001, those X-factor reductions were applied only to a portion of the ILECs' revenues. Because the ILECs had begun receiving Phase II pricing flexibility in numerous cities in late 2000, almost half of the ILECs' revenues were removed from price cap regulation before the 2001 annual access filing. And, even in those cities where special access services were still subject to price cap

[12] 47 C.F.R. § 61.45(b)(1)(iv).
[13] Throughout this period, GDP-PI was approximately 2 percent. Thus, application of a 6.5 percent X-factor would have yielded reductions of approximately 4.5 percent per year for four years. Instead, most LECs

regulation, the price cap reductions could only prevent the gap between price and cost from growing larger. The post-2001 price cap reductions did nothing to make up for the price cap reductions foregone in 1997-2000.

B. The Pricing Flexibility Order Eliminated Price Cap Regulation Prematurely

In those cities where the ILECs have received Phase II pricing flexibility during the past two years, the already-wide gap between cost and price created by the *Access Reform Order* and *CALLS Order* has only widened further. Even though prices in Phase II cities were already artificially elevated as a result of the years of foregone price cap reductions, a realignment of price to cost – which would have been expected to occur if the Phase II cities were truly competitive – has not materialized. Indeed, as AT&T explains in its petition, in many cities the ILECs have actually *increased* prices above the already-inflated prices in effect when the ILECs were granted Phase II pricing flexibility.

The Commission's expectation that Phase II cities would be sufficiently competitive to ensure that rates were just and reasonable was based on its "predictive judgment" about the effectiveness of the Phase II triggers adopted in the *Pricing Flexibility Order*. The ILECs' pattern of rate increases subsequent to the grant of Phase II pricing flexibility now shows that predictive judgment to have been wrong. In addition, the *number* of MSAs in which the ILECs have received Phase II pricing flexibility is at odds with the Commission's expectations when it adopted the *Pricing Flexibility Order*. On the day that the Commission adopted the *Pricing Flexibility Order*, the Chief of the Common Carrier

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applied the 6.5 percent X-factor in only one year – 1999 – and the special 3 percent X-factor in 2000.

Bureau indicated that the Phase II triggers would likely be met only in "a few" of the "largest metropolitan areas."[14] Similarly, the Commission told the D.C. Circuit Court of Appeals that it expected that the pricing flexibility triggers "are most likely to be satisfied initially in large urban areas, where competition could be expected to develop first."[15] Contrary to those expectations of limited relief, the ILECs have now obtained some form of Phase II relief in over half the MSAs in the nation, including such small cities as Dubuque, IA (MSA No. 286) and Owensboro, KY (MSA No. 293).

There are several explanations for the failure of the Phase II triggers to accurately determine whether an MSA is sufficiently competitive to constrain ILEC pricing.

1. Collocation is a Poor Indicator of Channel Termination Competition

In the *Pricing Flexibility Order*, the Commission acknowledged the "shortcomings of using collocation to measure competition for channel terminations."[16] However, in the absence of good data about the level of channel termination competition, the Commission found that a collocation-based test was "the best option available."[17] In making that finding, the Commission assumed that a CLEC would use collocation and ILEC channel terminations only on a transitional basis until it extended its own facilities to reach its customers.[18]

The experience of the past few years shows, however, that collocation by CLECs does not mean that CLECs will construct last-mile facilities that compete with ILEC

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[14] "FCC Approves Framework to Give ILECs Pricing Flexibility for Access Services," <u>Telecommunications Reports</u>, August 9, 1999.
[15] Brief for Federal Communications Commission, MCI WorldCom v. Federal Communications Commission, Case Nos. 99-1395/1404/1472 (D.C. Cir.), July 20, 2000, at 40.
[16] *Pricing Flexibility Order* at ¶ 104.
[17] *Pricing Flexibility Order* at ¶ 103.
[18] *Id*.

channel terminations. For example, recent WorldCom analyses provided to the Commission show that *even in those wire centers where CLECs have deployed fiber facilities*, CLEC fiber reaches less than 11 percent of the buildings where WorldCom purchases ILEC special access services.[19]

At a minimum, the relief provided by the *Pricing Flexibility Order* is overbroad. Whereas the *Pricing Flexibility Order* simply assumed that collocation was a transitional strategy and that CLECs could subsequently extend their fiber to additional customer buildings without limitation, the record developed in the Triennial Review proceeding and elsewhere shows that CLECs' construction of loop facilities is economically viable only in limited cases. In particular, because the cost of building "adds" for WorldCom has averaged about $250,000,[20] loop construction is economically viable only for high-traffic buildings (typically, those buildings that require multiple DS3s or SONET-level circuits). It is not economically viable for CLECs to extend their fiber networks to any of the hundreds of thousands of buildings that require only a single DS3 or a handful of DS1s. Phase II relief is overbroad because it allows the ILECs to escape price cap regulation for *all* channel termination services, even the lower-capacity DS1 and DS3 circuits for which CLEC alternatives do not exist today and are unlikely to exist in the future.

2. Even on Interoffice Routes, the *Pricing Flexibility Order*'s Tests are Only Loosely Correlated with Competitive Intensity

The collocation-based tests adopted in the *Pricing Flexibility Order* have other weaknesses, even on interoffice routes. One problem is that those tests "count" a wire

[19] Letter from Henry G. Hultquist, WorldCom, to Marlene H. Dortch, FCC, October 29, 2002 at 3 (attachment to letter from Ruth Milkman, Lawler, Metzger and Milkman, to Marlene H. Dortch, FCC, October 30, 2002, CC Docket Nos. 01-338, 96-98, 98-147).
[20] WorldCom Comments, CC Docket No. 01-338, April 4, 2002, at 75.

center even if, as is often the case, there is only a *single* collocator. For example, in the BellSouth special access pricing flexibility petition, fully 100 of the 237 wire centers with CLEC collocations were served by only a single CLEC.[21] The use of a test that can be satisfied by a duopoly market structure is inconsistent with the Commission's decisions in the AT&T streamlining proceedings; in those proceedings, the Commission eliminated price cap regulation for AT&T's business services only after finding that AT&T faced at least two large competitors, MCI and Sprint, as well as numerous smaller competitors.[22]

Another weakness of the collocation-based test adopted in the *Pricing Flexibility Order* is that it measures the number of wire centers in which CLECs *in the aggregate* have collocated. As WorldCom has shown, the network scope of CLECs in the aggregate is not as competitively significant as the network scope of individual competitors.[23] If customers have to incur the cost of coordinating and integrating services from multiple suppliers, the competitive pressure that can be brought to bear is diminished. Substantial competitive pressure develops only when the ILEC faces multiple competitors that *each* has network scope that is sufficient to be competitive with the ILEC. When the Commission eliminated price cap regulation for AT&T's business services in 1991, AT&T faced at least two competitors whose networks had similar nationwide scope to that of AT&T.

3. The Triggers are Too Lenient

Not only is the *Pricing Flexibility Order*'s reliance on collocations alone fundamentally flawed, but experience has shown that the thresholds, i.e., "triggers," adopted

[21] BellSouth petition for Pricing Flexibility for Special Access and Dedicated Transport Services, August 24, 2000, CCB/CPD File No. 00-20, Attachment 3.
[22] Competition in the Interstate Interexchange Marketplace, *Report and Order* 6 FCC Rcd 5880, 5888-5889 (1991).
[23]

in that order do not correlate with a level of competition sufficient to permit the elimination of price cap regulation. As the Commission candidly admitted in the *Pricing Flexibility Order*, it had only a limited record on which to base its selection of the triggers.[24] The ILECs' pricing behavior over the past two years, and the broad scope of relief received by the ILECs, shows that the triggers are too lenient.

Of particular concern is the "revenue" version of the triggers for interoffice transport. Due to the anomalous impact of the revenue allocation formula set forth in Section 69.725(c) of the Commission's rules, it has been especially easy for the ILECs to satisfy the revenue-based interoffice transport trigger. Section 69.725(c) permits the ILECs to allocate one half of a route's revenues to the office at each end of the route, thus allowing the ILEC to count one-half of that route's revenues towards the trigger even when there is a collocator only at one end of the route, i.e., even when there are no CLEC facilities on the route itself. The ILECs have exploited that anomaly in the rules; by relying almost exclusively on the revenue-based triggers, not the more difficult "percentage of offices" triggers, the ILECs have obtained Phase II pricing flexibility for interoffice transport in 84 of the top 100 MSAs, including 48 of the top 50 MSAs.

IV. Premature Deregulation Allows ILECs to Engage in Exclusionary Pricing

In adopting the *Pricing Flexibility Order*, the Commission assumed that compliance with the collocation-based triggers, would ensure that ILECs could not raise rates or adopt exclusionary pricing strategies. As shown above, compliance with the triggers has not prevented ILECs from raising special access prices, in some cases significantly. Nor does it prevent them from engaging in exclusionary pricing behavior.

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[24] *Pricing Flexibility Order* at ¶ 96.

One example of this type of pricing is provided by tariffs filed by BellSouth.[25] BellSouth's tariffs have the intent and effect of giving customers a strong incentive to put all new growth on BellSouth's network, rather than building or extending their own networks or using those of BellSouth's rivals. Indeed, in some instances putting certain levels of incremental growth on BellSouth's network may entitle customers to receive a credit. This kind of tariff is a threat to additional competitive investment.[26] Entrants will be understandably wary of investing in new facilities when they know that BellSouth is prepared to offer service for free in order to ensure that customers put all growth on BellSouth's network.

The opportunity to compete for incremental demand is particularly important for new entrants. It can be extremely difficult to migrate in-place circuits from the ILEC to new entrants. There may be non-recurring costs associated with "circuit-rearrangements," in which ILEC customer channel terminations are re-homed off of ILEC and onto competitive transport. Customers may also object to a circuit change which requires a disconnect. Moreover, these changes must be made during maintenance windows. Finally, some ILECs resist circuit migrations by placing unreasonable limits on the number of circuits that can be migrated.[27] Given all these constraints, discounts for incremental growth can create a significant barrier to new competitive investment.

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[25] *See, e.g.*, BellSouth Contract Tariff – No. 001 (issued August 24, 2001).

[26] The Commission recently reiterated that "targeted pricing discounts by an established incumbent with dominant market power may be used to eliminate nascent competitors and stifle competitive entry." In the Matter of Applications for Consent to the Transfer of Control of Licenses from Comcast Corporation and AT&T Corp., Transferors, to AT&T Comcast Corporation, Transferee, MB Docket No. 02-70, *Memorandum Opinion and Order* (rel. November 14, 2002), ¶ 120.

[27] *See, e.g.*, October 4, 2002 ex parte letter from Henry G. Hultquist of WorldCom to Marlene H. Dortch, describing limits placed by SBC and Verizon on circuit migrations. CC Docket No. 01-338.

The pricing flexibility triggers simply do not work as predicted. After receiving pricing flexibility, ILECs appear to be able to raise rates without fear of losing business competitors. The one instance in which ILECs have shown a willingness to lower rates, is as an incentive to capture all the growth needs of customers. This kind of incentive is a barrier to competitive investment. New entrants will not undertake the significant fixed and sunk costs of building local access networks unless they have some reasonable prospect of capturing incremental demand.

V. Conclusion

AT&T has shown that the BOCs' special access prices significantly exceed any reasonable measure of their actual costs to provide those services. It is clear that the Commission's pricing flexibility triggers do not function as intended. Instead of lowering prices to respond to the presence of competition in pricing flexibility MSAs, the BOCs have raised rates in those areas. Moreover, the absence of any competitive constraint on ILEC special access pricing in those MSAs, allows ILECs to engage in exclusionary pricing strategies that deter competitive investment.

Grossly excessive special access prices depress demand in network and equipment markets. They constitute a massive transfer from the ILECs' customers to the ILECs, as well as a substantial drag on the national economy. The Commission must face the fact that its pricing flexibility experiment has failed, and take decisive action to reduce ILEC special access prices to levels that will provide the ILECs with normal rates of return.

Respectfully submitted,

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